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IN THE

Supreme Court of the United States

October Term, 1942.

Nos. 11-19, 32.

IN THE MATTER OF

CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY,

Debtor.

GROUP OF INSTITUTIONAL INVESTORS and MUTUAL SAVINGS BANK GROUP,

Petitioners,

v.

CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY *et al.*,

Respondents.

RECONSTRUCTION FINANCE CORPORATION,

Petitioner,

v.

CHICAGO, MILWAUKEE, ST. PAUL AND PACIFIC RAILROAD COMPANY *et al.*,

Respondents.

Brief of United States Trust Company of New York as Trustee Under General Mortgage of Chicago, Milwaukee and St. Paul Railway Company.

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October 8, 1942.

INDEX

	PAGE
OPINIONS BELOW	2
JURISDICTION	2
ARGUMENT	2
Preliminary Statement	2
Foreword	6
The property subject to the first lien of the General Mortgage and the Plan's proposed treatment	8
I. It is the absence, not of formal findings, so designated or otherwise, but of the fundamental factual determination of compensation for destruction of priority of lien, that impels the remission of the Plan to the Commission	15
In a railway reorganization under Sec. 77 of the Bankruptcy Act, in providing for allotment to existing bondholders of new securities in a reorganized company, the principle of absolute priority must be faithfully observed and existing bondholders may not, except on receiving full compensation, lawfully be required to surrender their existing priority	17
Modification of rights must be predicated on facts definitely established	23
The principle of absolute priority precludes the destruction of the underlying lien unless full compensation be made	25
There was no determination, formal or informal, by the Commission or the court, of value in the inferior securities offered the underlying lienors to justify or afford compensation for the destruction of their prior lien	26
The things now claimed to serve as "compensation" for the destroyed priority are mere ordinary incidents of railway mortgages and have no elements or characteristics of compensation	30

PAGE

II. Should earnings subsequent to 1936 be taken into consideration? 34

III. The Plan imposed on bondholders now secured by an underlying mortgage the burden of a new mortgage made by a corporation obliged by its charter to operate a deficit line, thus unlawfully impairing the earnings pledged for the payment of our interest 39

IV. There was no factual foundation for the new contract with the Terre Haute which the Plan would have imposed on the reorganized road 52

V. By its mandatory additions and betterments fund the Plan would have unlawfully withheld from the General Mortgage bondholders $62,500,000 of first mortgage fixed interest bonds to which under their absolute priority they were entitled 55

In Conclusion 61

LIST OF AUTHORITIES CITED

	PAGE
Brooks-Scanlon Co. v. General R. R. Commissioner, 251 U. S. 395	46
Case v. Los Angeles Lumber Co., 308 U. S. 106	7, 18, 19, 23, 51
Matter of Chicago & North Western Ry. Co., 126 Fed. (2d) 351	28n, 34
Consolidated Rock Products Co. v. Du Bois, 312 U. S. 510	7, 19, 23, 25, 31, 51
Downtown Investment Assn. v. Boston Metropolitan Bldgs. Inc., 81 Fed. (2d) 314	18, 19
Hoard v. C. & O. Ry. Co., 123 U. S. 222	47
Kansas City Terminal Co. v. Central Union Trust Co., 271 U. S. 445	19
Louisville Bank v. Radford, 295 U. S. 555	20, 21, 22, 37
Louisville Trust Co. v. Louisville, N. A. & C. Ry. Co., 174 U. S. 674	19
Minneapolis & St. Louis R. R. Co. Reorganization, 241 I. C. C. 357	51
Northern Pacific R. R. Co. v. Boyd, 228 U. S. 482	5, 6, 19, 20
People v. O'Brien, 111 N. Y. 1	47
Railroad Co. v. Howard, 7 Wall. 392	19
Rogers v. Nashville, etc., Ry., 91 Fed. 299	46
W. B. Worthern Co. v. Kavanaugh, 295 U. S. 56	20

PAGE

Bankruptcy Act, Sec. 47 ..... 19, 20
Bankruptcy Act, " 77 ..... 14, 17, 18
Bankruptcy Act, " 77-B 18, 19

Cook on Corporations, Sec. 890 46

Interstate Commerce Commission, Report (1928) of Investigation of Chicago, Milwaukee & St. Paul Railway Co., 29 I. C. C. 620 ..... 29, 41, 42, 43, 44, 54n

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Opinions Below.

The reports and orders of the Interstate Commerce Commission are in 239 I.C.C. 485 and 240 I.C.C. 257 (Original Report, R. 2153-2269, and Order, R. 1258-1283; Supplemental Report, R. 1284-1317, and Order, R. 1319-1347). The opinion of the District Court is in 36 F. Supp. 193 (R. 1857-1899). The opinion of the Circuit Court of Appeals dated December 4, 1941, is in 124 F. (2d) 754 (R. 2297-2317). The *per curiam* opinion, of the Circuit Court of Appeals dated January 12, 1942, on the petition to modify its opinion of December 4, 1941, is not reported (R. 2334-5).

Jurisdiction

Jurisdiction is conferred on this court by Section 240 (a) of the Judicial Code (28 USCA Sec. 347) providing that in any case in a Circuit Court of Appeals it shall be competent for the Supreme Court of the United States to require by certiorari that the case be certified to it for determination. Certiorari has been granted.

ARGUMENT

Preliminary Statement

This brief is presented on behalf of United States Trust Company of New York as Trustee of the $150,000,000 General Mortgage of Chicago, Milwaukee & St. Paul Railway Company. This is the underlying mortgage on the heart of the system, secured not only by the 6,044 miles of main line but by equipment which as acquired up to the beginning of 1936 was valued at nearly $50,000,000, which amount has since been continuously augmented by purchases of equipment acquired by use of the earnings of the General Mortgage district. From its execution in

1889 to the present time the main lines of the Milwaukee on which our mortgage is the underlying lien have abundantly earned their mortgage interest, the few brief interruptions in the worst years of the depression having been more than made up in succeeding years. That the road is in a reorganization court is the result of no failure of earnings of the main lines on which our mortgage is the undisputed prior lien. It is one from the beginning which has been fully secured, and on all the most valuable and remunerative part of the system it has and has always had the absolute priority of the first lien.

Under the General Mortgage of the Chicago, Milwaukee & St. Paul Railway Company $138,788,000 of bonds are outstanding, bearing interest at various rates from 3½ to 4¾ per cent per annum. $11,212,000 of these bonds are pledged with the Reconstruction Finance Corporation as security for its loan to the railway company of approximately $12,000,000. There was also due on these bonds at the effective date of the Plan unpaid interest amounting to $17,580,193, making the total claim of the General Mortgage bondholders $156,368,193.

All these bonds are amply secured by the pledged property and their interest has been ever since their issuance more than amply earned. For one or two years during the depression the interest was not earned, but the deficit was more than made up in subsequent years. There is therefore an amply secured mortgage which is a first lien on the mortgaged property, which includes some 6,000 miles of railroad. For this amply secured prior underlying lien the proposed Plan would have given the General Mortgage bondholders new First Mortgage 4 per cent fixed interest system bonds amounting to $39,092,045, being 25 per cent of the said claim, these bonds being a part of an issue of $58,923,171, in addition to which various other liens would have been created which would have been on a parity with these bonds. The total of such other liens is about $21,929,000. In addition to these fixed

interest bonds the proposed Plan would have given to the General Mortgage bondholders as compensation for the destruction of 75 per cent of their prior underlying lien:

First: Series A Contingent Interest system bonds to the extent of 35 per cent of their claim, or $54,728,867; the total issue of these Series A bonds under the Plan to be $57,256,669, which bonds would have been preferred over the Series B bonds hereinafter mentioned only as to interest; the remainder of those bonds would have gone to Milwaukee & Northern Consolidated Mortgage bondholders.

Second: Series B Contingent Interest system bonds to the extent of 20 per cent of their claim, or $31,273,638, the total issue of these bonds to be $51,422,111, and practically all the remainder, or $19,084,621, would have been awarded to the holders of bonds on the western lines, a small residue going to Milwaukee & Northern Consolidated Mortgage bondholders.

Third: The remaining 20 per cent of the claim, which is $31,273,638, it was proposed to satisfy by an award of $31,273,638 of 5 per cent preferred stock at par of $100 a share; of the remaining preferred stock, $76,338,481, which is practically all of it, to go to the holders of bonds on the western lines.

In order for a court to determine whether these three classes of securities given to the General Mortgage bondholders are compensation for the destruction of their lien, facts must be found which will enable such a determination. It is the absence of such findings that requires the case to be sent back to the Interstate Commerce Commission.

The Circuit Court of Appeals has reversed the order of the District Court approving the Plan, basing its reversal on the absence of any definite determination of the

foundation of facts necessary to justify it. We submit that in thus reversing the order and remitting the proceeding to the Commission there was no error, and that such a ruthless subversion of prior liens, fully secured, as that proposed by the Plan cannot receive the sanction of this court.

The petitions for certiorari are founded on the contention that the Circuit Court of Appeals, instead of reversing Judge Igoe's order approving the Plan of Reorganization, should have affirmed it. We contend that in reversing the order the Circuit Court of Appeals did what it should have done. But the divergence between the petitioners and the Trustee of the General Mortgage, on whose behalf this brief is submitted, goes farther than the single question of whether or not the Circuit Court should have reversed. The chief reason given by the court below for reversing the order approving the Plan was that the Plan lacked the needed foundation of findings by the Commission; the court intimated that on the merits of the Plan it was inclined to share the District Court's approval, but that because the record was bare of the necessary findings the case should be sent back to the Commission with instructions to make findings, taking additional evidence, should the Commission deem it necessary. The petitioners contend that this was error; that the Circuit Court of Appeals had all the findings it needed to exercise its judgment as to the Plan and that it not only should have exercised its judgment and decided the issue of whether the Plan should have been approved, but that that court should have exercised its judgment in one particular way, namely by approving the Plan. On this contention they ask this court to reverse the Circuit's order and to affirm the order of the District Court approving the Plan.

We contend on the contrary that the Circuit Court of Appeals was correct in holding that there were not in the

record before the District Court findings justifying the Plan. But we believe that on the record before the Commission, and still more emphatically on that record augmented by the additional evidence in the District Court, there was not only no evidence, and, as the Circuit Court of Appeals correctly held, that there were no findings, to justify the Plan promulgated by the Commission, but that on that record it was positively and conclusively demonstrated that the Plan put forth could not properly receive judicial approval. The fundamental defects and inequities of the Plan would survive the formulation of findings. As the case is now in this court, it is altogether meet and proper that this court should pronounce clearly and unmistakably the fundamental principles basic in any plan of reorganization which is to receive judicial approval. Therefore we have not opposed the petitions to bring the case here on certiorari, but we ask that the court do not leave the fundamental issues to be decided piecemeal. Mere affirmance without something in the nature of a charter of instructions would simply remit the matter to the Commission with basic controverted questions still unresolved.

Foreword.

In this brief we shall not attempt to develop at length the underlying principles which must be faithfully observed in any plan of reorganization. The principle of absolute priority, meaning thereby that creditors of one rank of lien, or without lien, may not be provided for out of the assets available on reorganization to the displacement of property rights under liens of higher rank, declared in *Northern Pacific R. R. Co.* v. *Boyd* (228 U. S. 482), is recognized as one of the foundation stones of the law of reorganizations. Its unabated force in the field of reorganizations under the statute providing for corporate reorganization has been declared by this court

in *Case* v. *Los Angeles Lumber Co.* (308 U. S. 106) and *Consolidated Rock Products Co.* v. *Du Bois* (312 U. S. 510).

The principle of absolute priority does not mean that there may not be allotted to prior liens securities of a lower rank, nor that junior liens may not receive new securities of the same rank as those allotted to senior liens; but whenever the priority of existing lienors is thus disturbed full compensation must be made them and this must be based on a fair determination of respective values. Within these limitations, the Commission and the courts have a wide freedom of action in affecting through a Plan of Reorganization modification of existing contract rights. These fundamental principles have been so definitely established by the decisions of this court that we shall not elaborate them.

We fully appreciate the broadened scope of the power of administrative tribunals and of the practical difficulties imposed by the enormous complexity of the problems presented in a great railway reorganization. Consideration of paramount public interest negates the possibility of precise conformity of the final judgment with the strict legal rights held even by mortgagees. We realize that despite the tenor of the written obligation and sometimes even in apparent contradiction of it, liens most explicitly and solemnly created may lose their identity in a structure whereof it may only be said that it preserves in the broadest and most general way and in the light of ultimate values rather than of the terms of the covenanted obligation, the rights of secured creditors. Ours is not an obstructionist attitude. But the problem is not to be solved by any such airy generalization as the complacent observation of the advocates of the Plan that the difficulty is that there is not enough to go around and that the case presents nothing but the complaint of this interest and of that that it should have received more. This escapist attitude is altogether too easy a device for avoiding a real

problem. We come before this court to defend the rights created by a mortgage fully secured and its interest amply earned. Far-reaching as the powers of the administrative tribunal must be recognized as extending, one fundamental requirement is never absent. Indeed it is the recognition and unabated force of this requirement that makes it possible to fit the expanding power of administrative tribunals into the system envisaged by the constitution. That requirement is that the administrative tribunal must act upon definitely established facts. Within that limitation its powers are enormous, but within that limitation there is no room for the uncontrolled range of a benevolent purpose merely to distribute losses and to make a plan that will work.

Finding in the Plan propounded by the Commission no establishment or determination of the basic structure of facts necessary to sustain its drastic reconstruction of covenanted rights, the Circuit Court of Appeals has held that the proceeding must be sent back for the determination of those essential foundations. That judgment is right and should be affirmed, but in affirming it we trust that this court will pronounce clearly and unmistakably the definite principles that must be observed in the new plan if it is to survive judicial review.

The Property Subject to the First Lien of the General Mortgage and the Plan's Proposed Treatment.

Our underlying General Mortgage has at all times been and now is fully secured by the mortgaged property and its earnings. Of the $138,788,000 of bonds issued under our mortgage and outstanding in the hands of the public there is, including accrued interest unpaid, a total claim of $156,368,193; the remaining $11,212,000 principal of those issued are pledged with the Reconstruction Finance Corporation (2166) (hereinafter referred to as RFC).

Partial payments have been made on account of bond interest accruing since July 1, 1935, the date of initiation of this proceeding (*ib.*). Since the decision below some $16,000,000 more of accrued interest has been paid on the General Mortgage bonds. It is not disputed that these bonds are currently earning their interest several times over. From the period of their issue in 1889 to the present time not only has their interest been earned, but their mortgage district has carried the operating deficits on the other portions of the system, and the necessary purchases of equipment have largely been made from their earnings. The fact stands out that from the time this proceeding was begun in 1935 the General Mortgage district and its earnings have been adequate to carry the road and the Trustees have not been required to issue any trustees' certificates. The existing RFC loan of some $12,000,000, since substantially reduced, was obtained shortly before the trusteeship began, and for several years the road has had abundant cash resources to pay off the RFC and it might be paid tomorrow without the slightest embarrassment. These bonds are secured by a first lien on the main railway system of the Milwaukee. As reported by the Commission (2167):

> "The properties subject to the first lien of the general mortgage included 6,044 miles of road wholly owned, lying east of the Missouri River, 11.3 miles of road jointly owned, various trackage rights, 1,030 locomotives, 24,690 freight cars, 885 passenger cars, and 2,013 units of work equipment not subject to the lien of equipment trusts, 7,000 shares of the capital stock of the Chicago Union Station Company, and certain cash. Subject to the lien of equipment obligations totaling $25,031,319, the general mortgage was also secured by a first lien on 119 locomotives, 32,441 freight cars, 79 passenger cars, and 26 units of work equipment. It appears that no equipment deficiencies have been incurred under this mortgage."

The depreciated book value of this equipment owned outright, and of the equity in that owned subject to equipment liens, was shown by the testimony of the officer of the Debtor in charge of finances and accounting, under date of January 6, 1936, to have been approximately $49,000,000 (I.C.C. Exs. 74 and 114).

The lines west of the Missouri River, referred to in this proceeding as the western lines, running to the Pacific Coast, were constructed and acquired some twenty years after our mortgage was made (2162). Constructed and operated by a separate company, they were taken into the system in 1912, when the company owning them was consolidated with the mortgagor company.

Throughout the brief and on the argument the court will read and hear much about these western lines and what are usually referred to as the Fifty-year Fives, the bonds issued under the Fifty-year Mortgage on the western lines. This is practically a first mortgage on such lines. It is at present subject to the First and Refunding Mortgage, but all or practically all the bonds issued under that mortgage are pledged with the RFC, whose loan is to be retired by new First Mortgage bonds, so that for all practical purposes the Fifty-year Fives have a first lien on the western lines and this lien is generally so referred to. They have a second (for the moment a third but for all practical purposes a second) lien on the lines of the General Mortgage.

For its estimate of the system's earnings before fixed charges, the "probable prospective earnings" to be used in providing for fixed charges under Sec. 77 of the Bankruptcy Act, sub. (b), the Commission used two five-year averages, one 1931-5, showing $7,852,798, and the other 1932-36, showing $7,988,191. One at 1.16 per cent and the other at 1.18 per cent coverage would give the figures used by the Commission, as it points out in its report, and as the two amounts are so close and are both stated in the report, the Commission's finding of prospective earnings

is in effect the mean between the two, or $7,920,425 (2219). These figures are of course of several years ago. We do not know to what extent the court will consider it obligatory to bring the figures nearer to date. The trustees' evidence at the court hearing showed net earnings before fixed charges for 1940 (the last six months being estimated) of $14,079,381 (Debtor's Ex. 6 in District Court), and the actual earnings since 1936 down to the present year are at a very much higher level than in either of the five-year periods mentioned.

On the earning capacity of the western lines the Commission's report found (1307-8):

> "We are satisfied that on any reasonable basis of allocation between the lines west and the other parts of the system, the lines west cannot be expected to earn any sum for the payment of interest. In years when the system earnings approach $10,000,000, some interest is apparently earned for the 50-year mortgage bonds under the present capital structure, but this reflects system operation and does not demonstrate any earning power for the western lines."

Since the case came to the courts from the Commission, and most markedly since the decision now under review, the operation of the western lines has emerged from many years of deficits. This reflects the temporary closing of the Panama Canal and the tremendous activity of war-created traffic. In reporting the western lines' negation of earning capacity, the Commission was summarizing a view extending over many years. Certain it is that neither the Commission nor the court has found or stated any figures of actual value or earning capacity for the western lines.

Several issues of bonds referred to collectively as the Terre Haute bonds, aggregating $21,929,000, are obligations of separate railway corporations not undergoing reorganization in this proceeding. Their properties are leased to the Debtor under a long-term lease whereby the

Debtor assumed payment of the principal and interest of these bonds. 97 per cent of the stock of the Terre Haute is owned by the Debtor. The Plan provided for the affirmance of the lease and the assumption by the reorganized company of payment of principal and interest of the bonds. The Terre Haute bond interest was made a fixed charge on the new company to the extent of 2¾ per cent and an additional 1½ per cent interest is made a contingent charge. The Terre Haute is chiefly a coal road used as the carrier for most of the coal required in the Debtor's operations.

There is a First and Refunding Mortgage with $8,923,000 of bonds outstanding. This mortgage is secured by a first lien on the western lines, a second lien on the General Mortgage lines, and a first lien on certain sundry collateral including the Terre Haute stock (2170-1). All these First and Refunding mortgage bonds are pledged, most of them with the RFC as part of the security for a loan of approximately $12,000,000 (*ib.*, 2170). This loan is admittedly fully secured, and the Plan allotted to the RFC new First Mortgage bonds for the full amount of its loan (1317). The Fifty-year Five per cent bonds amounting to $106,395,096 are secured by a second lien on all the property on which the First and Refunding mortgage is a first lien, and by a third lien on all the property on which the First and Refunding mortgage is a second lien (2172).

There are a few pieces of line integrated with the General Mortgage lines, acquired since the execution of that mortgage, which are referred to as the "pieces east". Their earnings for a typical year are shown as $170,000. There is a controversy as to whether they are covered by the after-acquired property clause of the General Mortgage and thus subject to its first lien, or on the other hand do not fall within it and are therefore subject to the first lien of the First and Refunding Mortgage and to the second lien of the 50-year mortgage (2252).*

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* V. footnote, p. 30.

Under the Plan (1317), as briefly summarized, *supra*, pp. 3, 4, there was to be a First Mortgage on the entire system, including not only the main railway system subject to our mortgage but other lines acquired many years after our mortgage was made, specifically the so-called western lines from the Missouri River to the Pacific coast. New First Mortgage system bonds were to be presently issued for distribution among various classes of security-holders to the amount of $53,923,171, in addition to which the new company was to assume the obligations of the $21,929,000 of Terre Haute bonds. The holders of the present General Mortgage bonds were to receive $39,092,049 of new First Mortgage bonds, being 25 per cent in par value of their present holdings, an amount based on a capitalization of probable future earnings which excluded $2,500,000 per year of such earnings from capitalization and gave us no fixed-interest or First Mortgage bonds based on that portion of the earnings but diverted it to an additions and betterments fund for future capital requirements year by year. The Plan also provided for new contingent-interest mortgage bonds of two series, of which the present General Mortgage bondholders were to have Series A bonds to the extent of 35 per cent, or $54,728,867, and $31,273,638 of Series B bonds, this being 20 per cent of the par value of their present holdings. As between these two series, the Series A bonds were to be prior in charge as to interest only. Along with the issue to us of $31,273,638 of Series B bonds, $19,084,621 of the same issue were to go to the present holders of the Fifty-year Mortgage 5 per cent bonds now secured by the western lines, on which our mortgage is not a lien and whose only lien on our mortgaged lines is admittedly a subordinate one. This left 20 per cent of the par value of the General Mortgage bonds still to be provided for, and this was accomplished by alloting to their holders such 20 per cent in new preferred stock. The new preferred stock thus allotted to them would have amounted to $31,273,638 (at $100 par), but the greater

part, or $76,338,481, of the $111,347,846 of new preferred stock was to go to the Fifty-year Mortgage bonds. Thus the only new First Mortgage bonds for the General Mortgage bondholders would have been in the amount of 25 per cent of their present holdings, a total of $39,092,049, among the $53,923,171 to be presently allotted, or among $69,273,471 of fixed-interest portion of bonds if we include $15,350,000 fixed-interest portion of the Terre Haute bonds whose obligation was to be assumed.

This was the Plan of Reorganization reported by the Commission and, with slight modification or corrections, approved by the District Court.

The Circuit Court of Appeals reversed this order of approval and directed that court to send the proceeding back to the Commission, primarily for the purpose of making definite findings and determinations on essential issues of fact as to which no determination could be found in the record.

The Circuit Court of Appeals found that there was no factual background which would justify a plan so drastic in its subversive of priorities. In the Commission's report the Circuit Court searched in vain for those determinations of established facts which would have justified it, and accordingly reversed the order of the District Court approving the Plan and remanded the proceeding to the Commission. We submit that in so doing the Circuit Court committed no error. Such a Plan did not meet the requirements imposed by law for a plan of reorganization; it was unfair and inequitable and not in conformity with the law of the land and unlawfully deprived our bondholders of their property in violation of law and of the Fifth Amendment to the constitution of the United States. Its manifest departures from the standards imperatively laid down by Sec. 77 of the Bankruptcy Act ignored a mandate which but recognizes and incorporates in the Bankruptcy Act certain fundamental principles required by the constitution and the law of the land.

But in affirming this action of the Circuit Court in sending the case back to the Commission, it is in the interest of justice and in the vital public interest that this court declare and so far as needful formulate those inherent and fundamental requirements that must inexorably be recognized and applied by the Commission. Otherwise this reorganization will be protracted beyond reasonable limits and the present errors and unjustifiable subversion of recognized principles may be repeated and require probably several years for their judicial correction through the slow process of future appeals.

I.

It is the absence, not of formal findings, so designated or otherwise, but of the fundamental factual determination of compensation for destruction of priority of lien, that impels remission of the Plan to the Commission.

The initial question directly presented by the petitions is whether, in its decision that the Plan could not properly be approved in the absence of definite findings or determination of the ultimate facts upon which the Plan was based, the Circuit Court of Appeals committed error. We agree with the petitioners that the labelling of findings as findings is not essential and that those things which in its report the Commission formulated and propounded as established statements of ultimate fact may be regarded as the equivalent of findings and serve as the "reasons for its decision" enjoined by the statute. Indeed, the Circuit Court of Appeals itself so declared (124 Fed. (2d) 754, 766):

> "Our criticism is not directed to the fact that the findings were embodied in the Commission's report (a large part of which is devoted to a discussion

> and statement of the evidence) rather than stated specifically as findings. But the fault lies in the fact that we are left uncertain, or in the dark, as to the finding of the Commission."

The infirmity of the Plan and of the order of the District Court approving it, the infirmity for which the Circuit Court of Appeals has reversed it and sent it back to the Commission, is one running far deeper than mere informality of verbiage.

The Circuit Court of Appeals plainly intimated that on the whole it thought that in its broad outlines such a plan would be a pretty good one *if the necessary foundation of established facts had been found to exist.* The trouble was that even to a court obviously sympathetic with the Plan, looking at it with a distinctly approving eye, it was simply impossible to give it judicial approval in the absence of the necessary establishment of those basic facts upon which the legality of the Plan would have had to be predicated and without which it would be clearly confiscatory.

We say "in its broad outlines;" an important limitation. For the Circuit Court did not go so far as to say that the Plan as it stood was fair and equitable; it stopped far short of approval of the treatment of the bondholders of the underlying General Mortgage, on whose behalf this brief is submitted—a vital and impressive omission in the case of the first mortgage on the heart of the road; the first lien on what through the years has been the remunerative base and core of the system, without which the Milwaukee would never have been the steady earner of revenues. The indefensible allotment to these bondholders presented, as the court said, "a serious question" (124 Fed. (2d) 754, 765).

It is the characteristic feature of the reorganization statute, and of plans of reorganization put forth under its sanction, that the rights of creditors may, to use the language of the statute, be "modified." We are quite sure that in the light of this court's decisions no one

would at this late date contend that this statutory grant was a roving charter to scrap a railroad's existing liens and to erect on their ruins a new capital structure wherein existing liens were subverted and a new corporation formed which to be valid need only present simplicity of structure and reasonable assurance against future insolvency.

In a railway reorganization under Sec. 77 of the Bankruptcy Act, in providing for allotment to existing bondholders of new securities in a reorganized company, the principle of absolute priority must be faithfully observed and existing bondholders may not, except on receiving full compensation, lawfully be required to surrender their existing priority.

Under this reorganization statute (Sec. 77 of the Bankruptcy Act) reorganization, where found practicable, supersedes foreclosure. It must be recognized that some of the remedies that foreclosure made available to bondholders are taken away. Thus the mortgagee may not insist on sale of the property to satisfy his lien; the maturity date of his mortgage may be extended. The essential feature of the system is that the mortgagee may be required to gave the mortgagor road an opportunity to rehabilitate its financial system and to scale down the fixed interest so that the mortgagor's failure, even for a substantial period, to earn interest requirements will not necessarily involve loss of the enterprise. To authorize this, the law requires that a fair determination be made of the probable prospective earnings of the road, in the light of its past experience "and all other relevant facts." The prospective earnings being thus arrived at, such amount becomes the keystone of the new financial structure, and mortgages, whether with fixed or contingent interest or with both, are contemplated in such amount that there will be reasonably safe coverage for their interest charges.

When Sec. 77 and Sec. 77-B came into our law the principle of the *Boyd* case (*Northern Pacific Railway Company* v. *Boyd*, 228 U. S. 482) had long been one of the most widely recognized, best established and most characteristic principles of the law of reorganizations. That principle was that any arrangement of the parties to a reorganization by which the rights and interests of stockholders were attempted to be secured at the expense of the prior rights of creditors (secured or unsecured) came within judicial denunciation and would not be allowed to stand. After the enactment of these companion statutes, both in language almost identical prescribing as a necessary element in any plan of reorganization that it be fair and equitable and specifically declaring in the case of Sec. 77 that it must not discriminate unfairly in favor of any class of creditors or stockholders, a doubt was occasionally suggested whether the standard imposed by the *Boyd* case was equally mandatory in reorganization proceedings under Sec. 77 or Sec. 77-B. Indeed, it was even suggested by the Circuit Court of Appeals for the Second Circuit (*Downtown Inv. Ass'n* v. *Boston Metropolitan Bldgs., Inc.*, 81 Fed. (2d) 314, 323-4), a decision out of line with most of the cases that more or less touched the question, that the principle of the *Boyd* case was inapplicable to these statutory reorganizations.

That question, however, is no longer an open one. By its decision in *Case* v. *Los Angeles Lumber Co.* (308 U. S. 106), this court has unequivocally declared that the "fixed principle" of the *Boyd* case is a vital and fundamental part of the new administrative and judicial process provided by the reorganization statutes. These statutes, it will be recalled, provide that to secure judicial approval the plan must be "fair and equitable," a mandate not to lapse into the impotence of a glittering generality, but imperatively enjoining adherence to a basic and fundamental conception long familiar to the law. "The words 'fair and equitable'" declares the court, are recognized

as having "acquired a fixed meaning through judicial interpretations in the field of equity receivership reorganizations." (p. 115). The rule of priority stated above is formulated as the "fixed principle" declared in the *Boyd* case, along with the familiar decisions in *Railroad Co.* v. *Howard*, 7 Wall. 392; *Louisville Trust Co.* v. *Louisville, N. A. & C. Ry. Co.* (174 U. S. 674) and *Kansas City Terminal Ry. Co.* v. *Central Union Trust Co.* (271 U. S. 445), and after a review of the cases the court categorically declares (p. 119):

> "Hence we conclude, as have other courts, that that doctrine is firmly imbedded in Sec. 77-B."

In the footnote it is declared (p. 119, n. 14) that "intimations to the contrary," as in the *Downtown Investment Assn.* case above referred to, "are not tenable."

And more recently, in *Consolidated Rock Products Co.* v. *Du Bois* (312 U. S. 510), this court again emphatically reaffirms the principle of absolute priority and the unabated force of the principle declared in the *Boyd* case:

> "Whether a company is solvent or insolvent in either the equity or the bankruptcy sense, 'any arrangement of the parties by which the subordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights' of creditors 'comes within judicial denunciation'" (p. 527).

The fixed principle of the *Boyd* case thus declared to be firmly imbedded in Sec. 77-B is of course equally firmly imbedded in Sec. 77, for the former section's requirement that the plan be fair and equitable is carried word for word into Sec. 77, and indeed reinforced by a specific prohibition of unfair discrimination. "Absolute priority" is this court's own characterization of the requirement—"*this rule of full or absolute priority*" (*Case* v. *Los Angeles Lumber Co.*, 308 U. S. 106, 117).

Therefore in the case at bar we do not have to restate the reasons why Sec. 77 should be regarded as imperatively subjecting railroad reorganizations to the rule of absolute priority declared in the *Boyd* case. This court having established this once and for all, the only question in the particular case is whether the rule of absolute priority has in fact been violated. The principle of "absolute priority" extends its protection to each successive interest in the hierarchy of liens. Stockholders may not be provided for until creditors have been paid or provided for, and junior lienors may not be provided for until senior lienors have been paid or provided for.

In the case at bar, the action of the administrative body, ruthlessly eliminating from the General Mortgage bonds much of their vitality, seems to have been promulgated by the Commission and uncritically accepted by the District Court in utter disregard of the repeated admonishments of this court. In the leading case of *Louisville Bank* v. *Radford* (295 U. S. 555) the court had to consider the nature of a mortgagee's rights in the light of the bankruptcy power. In the opinion, wherein Mr. Justice BRANDEIS speaks for a unanimous court, the limitation of the scope of a "public interest" claimed to be potent to extinguish property rights is emphatically declared. The case involved the constitutionality of the Frazier-Lemke Act of 1934, a statute for the relief of mortgage debtors. The court, referring to previous cases, such as *W. B. Worthen Co.* v. *Kavanaugh* (295 U. S. 56), decided the month before, says (p. 578):

> "There we said: 'With studied indifference to the interests of the mortgagee or to his appropriate protection they have taken from the mortgage the quality of an acceptable investment for a rational investor'; and; 'So viewed they are seen to be an oppressive and unnecessary destruction of nearly all the incidents that give attractiveness and value to collateral security.'"

Emphasizing the recognized vested character of the property right of the mortgagee's lien, as distinguished from his cause of action for the debt, the court says (pp. 579-580):

> "No instance has been found, except under the Frazier-Lemke Act, of either a statute or decision compelling the mortgagee to relinquish the property to the mortgagor free of the lien unless the debt was paid in full.
>
> "This right of the mortgagee to insist upon full payment before giving up his security has been deemed of the essence of a mortgage."

On this the court says (pp. 588-590):

> "It is true that the position of a secured creditor, who has rights in specific property, differs fundamentally from that of an unsecured creditor, who has none; and that *the Frazier-Lemke Act is the first instance of an attempt, by a bankruptcy act, to abridge, solely in the interest of the mortgagor, a substantive right of the mortgagee in specific property held as security.** But we have no occasion to decide in this case whether the bankruptcy clause confers upon Congress generally the power to abridge the mortgagee's rights in specific property. Paragraph 7 declares that 'the provisions of this Act shall apply only to debts existing at the time this Act becomes effective.' The power over property pledged as security after the date of the Act may be greater than over property pledged before; and this Act deals only with preëxisting mortgages. *Because the Act is retroactive in terms and as here applied purports to take away rights of the mortgagee in specific property, another provision of the Constitution is controlling.*
>
> "Fourth. **The bankruptcy power like the other great substantive powers of Congress, is subject to the Fifth Amendment.** Under the bankruptcy power Congress may discharge the debtor's personal obli-

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* Throughout this brief, unless otherwise stated, italics are ours.

gation, because, unlike the States, it is not prohibited from impairing the obligation of contracts. Compare *Mitchell* v. *Clark*, 110 U. S. 633, 643. But the effect of the Act here complained of is not the discharge of Radford's personal obligation. It is the taking of substantive rights in specific property acquired by the Bank prior to the Act."

The General Mortgage Trustee and its objecting bondholders come into court vested with the rights inherent in the mortgage grant of the heart of this railway system. It is at their expense that the Commission's Plan would, under the guise of public interest, fasten in perpetuity on the operation of this mortgaged property the operating deficits of a railway enterprise taken on by their debtor years after their bonds were issued. It is at their expense that the Commission's Plan would each year withdraw from the earnings, pledged for the payment of their bond interest, amounts desired for additions and betterments (totaling for the period more than $20,000 per mile) which during the life of the mortgage will aggregate $125,000,000, five-sixths of our total present mortgage. "Public interest" is indeed made a universal solvent of property right. We can not better take leave of the subject than in the concluding language of *Louisville Bank* v. *Radford* (209 U. S. 555, pp. 601-2):

> "The province of the Court is limited to deciding whether the Frazier-Lemke Act as applied has taken from the Bank without compensation, and given to Radford, rights in specific property which are of substantial value. Compare *Ochoa* v. *Hernandez*, 230 U. S. 139, 161; *Loan Association* v. *Topeka*, 20 Wall. 655, 662, 664; *In re Dillard*, Fed. Cas. No. 3,912, p. 706.
>
> "As we conclude that the Act as applied has done so, we must hold it void. For the Fifth Amendment commands that, however great the Nation's need, private property shall not be thus taken even for a wholly public use without just compensation. If the public interest requires, and permits, the taking of

property of individual mortgagees in order to relieve the necessities of individual mortgagors, resort must be had to proceedings by eminent domain; so that, through taxation, the burden of the relief afforded in the public interest may be borne by the public."

Modification of rights must be predicated on facts definitely established.

There is a wide field for the permitted modification of rights. Maturities may be postponed; interest rates may be reduced; leases may be annulled. Interest now secured as a fixed obligation may be made contingent, to be paid only if earned. Most important perhaps of all, it is permitted that in place of existing senior lien securities, a creditor may, *if full compensation be made*, be required to take securities of a lower rank or to spread the coverage of his new securities so as to include like provision for other creditors of lower rank. Both these measures of impairment would under the proposed Plan have been visited on the General Mortgage bondholders. For a substantial part of their present fully secured claim they would have been required to take second mortgage securities, and income bonds at that, and as to part of these they would not have received the whole lien but would have been required to spread the coverage of their mortgage so as to take in new bonds issued to creditors having merely a second lien on the property on which the General Mortgage was a first lien, thus diluting and impairing to that extent the present security of the General Mortgage bondholders; and for the remainder of their claim they would have received a small minority interest in a large issue of preferred stock.

Under the fundamental principles announced by this court in the *Los Angeles Lumber Company* and *Consolidated Rock Products* cases, such a dilution and subordination of lien would unlawfully violate the fundamental

principle of the maintenance of existing absolute priority *unless* full compensation were afforded the General Mortgage bondholders for the loss of their first lien position. The Circuit Court of Appeals might well have believed it possible that the facts in the Milwaukee situation *might* authorize a conclusion that such compensation was afforded by the Plan. We say the court might have believed it possible; we might say that it must have believed it possible, because if it were not possible the Plan could not be saved, then or thereafter, and the court evidently believed that a plan of that kind might, if based on sufficient foundation of established and adjudged facts, ultimately receive judicial approval. No one disputes that the first lien position of the General Mortgage would as to its greater part have been subverted, nor that under the Plan its bondholders would have been required to share their new securities and new lien position with creditors of inferior rank, and under the established principles repeatedly announced by this court such impairment, unless compensation were made, would have been unlawful. Even inclined as the court evidently was to look not unfavorably on a plan such as that proposed, it fully realized that such a displacement and shifting of liens could not have judicial approval unless nor until the requisite foundation had been laid in the way of facts definitely established. It was not merely, as petitioners seem to conceive, a lack of something in the record labelled "Findings"; it was the absence of definite determination of required facts. As the court said, emphasizing by its own use of italics here quoted, the fatal defect of the record before it (*In re Chicago, Milwaukee, St. Paul & Pacific R.R. Co.*, 124 Fed. (2d) 754, 766):

> "Reluctant as we are to do so, we nevertheless feel that under the decision of this controlling case, there must be a return of the cause to the District Court with direction to the District Court to return it to the I. C. C. and for that body to make the find-

ings on issues vital to the question of values and equities as announced in said Consolidated Rock Products case. *Likewise, the findings must be so specific that the court may definitely see that in the new plan, provision for full compensation of cancelled old senior securities, and all prior preferred positions, is made.* The findings must be sufficiently complete on these matters, that the court may, from its examination, ascertain whether full compensation has been made for the entire bundle of rights which each of the creditors is called upon to surrender."

The principle of absolute priority precludes the destruction of the underlying lien unless full compensation be made.

What were these essential fundamental facts which would have to be established to justify the threatened impairment of the first mortgage lien? It does not seem necessary to retraverse the ground so thoroughly explored by this court in the *Consolidated Rock Products* case. In its judgment reversing the District Court's approval of the proposed Plan the Circuit Court of Appeals faithfully followed the path blazed by that authoritative decision. It adopted its principles as its sure guide, declaring its "explicit holding" to be "mandatory" (124 Fed. (2d) 754, 766).

Under the *Consolidated Rock Products* case "there must," said the court below, "be an approximate ascertainment of the value of the respective assets where different liens cover different properties" (124 Fed. (2d) 754, 763); a determination inexorably required where, as here, the Commission has provided for new lien securities wherein the old liens are commingled and their identity destroyed. It is in such a situation that we have application of the declaration reaffirmed in the *Consolidated Rock Products* case that

> "The absolute priority principle does not prevent creditors from being given inferior grades of se-

curities or securities of the same kind as given to junior interests, provided the senior lienholders are given securities of the value equal to the value of liens displaced" (124 Fed. (2d) 754, 763).

Under the proposed Plan inferior securities and securities of the same kind as given to junior interests would have been allotted to senior lienors. The General Mortgage bondholders, holding an undisputed first lien on the heart of the system, a remunerative railroad that had always earned and is now earning such first mortgage interest, would have been required to receive the bonds of a corporation obliged by its charter to operate an added line, running from the Missouri River to the Pacific coast, not built or dreamed of when the first mortgage was given and operated for some thirty years at a staggering deficit cast year by year against the earnings of the original mortgaged line. The bondholders of such new line were to share in some of the issues of new securities allotted to the first mortgage bondholders. The only lien they held on the old line was admittedly a junior mortgage lien subordinate to that of the first mortgage. The only compensation, if compensation it could have been called, the first mortgage bondholders were to receive for this subversion of their "absolute priority" and dilution of their lien was the inclusion within their new mortgage of a lien on such western deficit line which their mortgage company would be obliged to operate.

There was no determination, formal or informal, by the Commission or the court, of value in the inferior securities offered the underlying lienors to justify or afford compensation for the destruction of their prior lien.

Naturally enough, such a proposal disturbed the Circuit Court of Appeals. There was, it declared (p. 765), "a serious question presented due to the small percentage

(25%) of the (new) First Mortgage bonds given to the holders of old General Mortgage bonds". "Our suggestion is", the court continued (*ib.*) "that if any revision should be made, this percentage might be increased". In their present brief counsel for the Group of Institutional Investors, who, along with the Savings Bank Group and the heavily secured Reconstruction Finance Corporation, are supporting the Plan, woefully distort the criticism of the Circuit Court of Appeals. They seem to regard that court's withholding of approval as based on the lack of formal findings; a gloss which the court below anticipated and refuted as already quoted. The Plan is contrary to law because, destroying in major part existing priorities, it gives no compensation. To sustain such a plan it would have to be shown—whether by formal "findings" or in other definite determination—that the new and different securities which holders of prior liens were to receive had in fact value, earning power of a kind and amount representing compensation for the destroyed priority. As the Circuit Court of Appeals found neither in the Commission's report nor in the decision of the District Court any such determination, it properly decided that it could not approve the Plan and sent the proceeding back to the Commission. Counsel for the petitioners treat this as meaning that the Circuit Court of Appeals was insisting on what are called single sum valuations, or dollar valuations. It is enough, they insist, that the Commission take into consideration the property and its earning capacity and perhaps the earnings of its constituent parts, and then make up an allocation of securities that fairly reflects the different values entering into the whole picture.

This is really putting up a man of straw to represent the judgment of the court below. It is not a question of single sum valuations or dollar valuations. It is a question of the right and duty of the judicial tribunal to have before it the fundamental elements on which alone the determination can be made of whether or not compensa-

tion has been given for the loss of priority. Even though values may be expressed in terms of earning capacity, and even though to a secured creditor there may be awarded asset B earning so much a year in place of asset A earning the same amount and one need not find the capital value of A, the criticism of the court below goes far deeper than that. The absolute priority of the underlying General Mortgage would have been destroyed and its bondholders required to accept a fraction of a mortgage on a line as to which there was no finding, or determination in whatever form, of the existence of earning capacity. In respect to the additional mortgaged property the bonds on which were injected into and diluted the lien of the new securities offered the underlying bondholders, there was no determination of any elements of value to compensate the underlying bondholders for the destruction of their prior lien position. The objection was not the lack of formal findings or of single sum valuations or dollar valuations; it was the complete absence of showing of value. Indeed there could have been no such determination of value without making the Commission's Plan utterly inconsistent with itself and self-destructive, for the Commission explicitly found (1307):

> "We are satisfied that on any reasonable basis of allocation between the lines west and the other parts of the system, the lines west cannot be expected to earn any sum for the payment of interest."

The evidence of system operation, it is found (1307-8; Commission's Report of June 14, 1940)

> "does not demonstrate any earning power for the western lines." *

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* Recent increased earnings are subject to the criticism of the United States Circuit Court of Appeals in the *Chicago and Northwestern* case (126 Fed. (2d) 351, 364; 7th Cir.), as "temporary and * * * not to be taken too seriously when viewing the long future of this railroad."

It is urged by the petitioners that there were other elements from which some earning capacity might be attributed to the western lines; such, for example, as their contribution as a feeder and originator of system traffic. The fallacy of this is that no such values were found by the Commission. On the contrary, the Commission explicitly found, as stated above, the non-existence of earning power. All that the claim amounts to is that there are certain kinds of elements of value in connected lines which are sometimes reflected in increased earnings of a main line. That such elements actually existed here was not shown; and their existence not being shown there was of course no value ascertained.

In its investigation of the Milwaukee following the last reorganization, wherein the Commission reviewed at length the history of the acquisition of the western lines and their proper place in the system, the Commission had said (Report of Investigation of Reorganization of Chicago, Milwaukee & St. Paul Railway Company, 29 I.C.C. 615, 619; introduced in evidence, 1721):

> "There is nothing in this record which shows that the burden of the system is lightened to a substantial extent by indirect benefit to the system."

The nearest approach to evidence in support of the claims of the western lines was the testimony of the witness Parker, but he outlined his views of the proper organization of a segregation study rather than undertook the onerous task of reaching one. The Commission recognized that no actual evidence was before them enabling them to make any finding, and declined to make any. As the Commission said of the witness (Report, p. 2254):

> "The comment may be made that he did not attempt a new analysis of each mortgage division consistent with his revision of the debtor's study for the western lines. We think that if the earnings studies for 1936 are to be rejected there is no satisfactory substitute short of a new segregation study embracing the entire system."

The earnings studies for 1936, there referred to, showed a deficit for the lines west of $1,108,525, a deficit not wiped out even if there were credited the $170,100 net earnings of the pieces east and the $402,031 income from securities pledged as collateral to the First and Refunding mortgage (on which the Fifty-Year Fives have a second lien (2219-2220)). Thus there was not only no finding of any contribution by the property subject to the Fifty-Year Fives, but there was an explicit statement by the Commission that it had no evidence before it on which such a finding could be based.*

The things now claimed to serve as "compensation" for the destroyed priority are mere ordinary incidents of railway mortgages and have no elements or characteristics of compensation.

Counsel for the Groups, recognizing the fatal want of compensation for the subversion of the lien of the underlying mortgage, seek to discover in the record something that may pass muster for the establishment, even though informal and inferential, of value. "In recognition of their prior rights," the explanation begins (Brief, p. 54), but the "their" embraces not only the underlying bondholders with their first lien on the heart of the system, but is here used to include the holders of the Fifty-Year Fives, who so far as that property is concerned are not

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* The pieces east received at the hands of the Commission less consideration than their importance demanded. The relative magnitude of their earnings and the necessity of recognition of their inclusion within the lien of the General Mortgage are shown in the brief for the Princeton University Group of General Mortgage bondholders. The Commission looked askance on the claim of the Fifty-Year Fives to a first lien on these pieces east, but apparently gave them the benefit of it. Here again was revealed the fatal infirmity of the Commission's report and Plan in its altogether casual disposition of a substantial feature, without any clear determination of the facts.

and never have been senior creditors at all. Those whom counsel in the same sentence declare they are speaking of as "senior creditors" are "the holders of the old bonds which are senior to the Adjustments!" The Adjustments come at the far end of all the bonds given to all the other mortgages. To compensate *these* senior creditors, it is said, meaning everything ahead of the Adjustments, the Plan provides "certain valuable rights and characteristics."

Bear in mind that we are looking for that compensation which in the *Consolidated Rock Products* case this court has said must be provided for those whose absolute priority is taken from them. What we are speaking of is not the whole body of creditors senior to the most remote security; it is the underlying bondholders senior to all liens except their own; here the General Mortgage bondholders.

These "certain valuable rights and characteristics" are then described (Brief, pp. 54-5). It seems that they consist chiefly of the voting trust! "Control," it is said (p. 54), is "assured." This would be poor consolation for the subversion of priorities, and we can hardly believe the suggestion is serious, but it appears on the face of it that control is not given to—nor indeed has it been asked by—the underlying bondholders. Control is vested in five voting trustees, of whom one is to be named by the Institutional Investors' Group, one by the Savings Bank Group, one by the Reconstruction Finance Corporation, one by the Protective Committee for the Fifty-year Fives and one by the trustee of the Adjustment Mortgage. The only representation of the General Mortgage is by the two nominees of the groups, who hold mortgages of various issues. It is only the two junior mortgages, the Fifty-year Fives and the Adjustments, that have direct representation in the voting trustees. The General Mortgage trustee has no criticism to offer as to this, but to call it assurance of control, given as compensation for subversion of priority, is a strain on the language.

The other "valuable rights" adduced on page 55 of the brief for the Groups as furnishing compensation for the destruction of priority are nothing more than normal features such as are frequently found in any railway mortgage.

Where in these things thus enumerated is found any determination—not necessarily a finding labelled as such, but any determination of any kind, formal or informal—of any value given the old underlying bondholders to compensate them for the destruction of their priority? The important element of earning capacity is not discovered among them, although pages are taken in describing the illusory "control" and routine features of a new mortgage. At the end (p. 68) there is a paragraph of a dozen lines bearing the promising heading "Findings as to Each of the Several Mortgage Divisions," but the text fails to fulfill the promise of the sounding title. Not a single reference is given to chapter or verse; not a single actual citation of anything in the record. "The Commission," it is said, "investigated with care and made numerous findings as to the relative earning power of the different divisions, their relative importance to the reorganized company, the desirability of their continued operation in the public interest and their value in terms of new securities in the reorganized company." It is a pity that counsel did not fortify this with references to the places in the record where these things were to be found.

We are dealing for the moment with the underlying lien of the General Mortgage on the heart of the road (2167), not only covering the main line itself but a first lien on equipment and equity in equipment having a depreciated book value in 1936 of approximately $49,000,000 (ICC Ex's 74 and 114), since augmented by heavy purchases of equipment made year by year out of its operating income.

Where are the findings, formal or informal, the found facts, the determination or even the suggestion of the existence in the western lines, with whom the Plan had proposed to throw us in as compulsory fellow-travelers under the new mortgage and preferred stock, of earning capacity that might import value as compensation for our lost lien? At the cost of repetition, we quote again the explicit finding of precisely the contrary; namely (1307-8):

> "We are satisfied that on any reasonable basis of allocation between the lines west and the other parts of the system, the lines west cannot be expected to earn any sum for the payment of interest. In years when the system earnings approach $10,000,000 some interest is apparently earned for the 50-year mortgage bonds under the present capital structure, but this reflects system operation and does not demonstrate any earning power for the western lines."

What could the court below have properly done but to reverse the approval of the Plan for want of findings, determination, adjudged establishment of facts showing something at least suggesting that some kind of compensation was afforded for the destruction of the priority of the underlying mortgage?

As the Circuit Court of Appeals properly said (124 Fed. (2d) 754, 766):

> "It would be begging the question to assume that findings were necessarily made by the I. C. C. when the allocation was made. We would be delegating to the I. C. C. an obligation which is ours. The Commission must formulate its plan. It must make fact findings supported by the evidence upon which its plan is based. We must independently determine whether the plan is fair and equitable."

II.

Should earnings subsequent to 1936 be taken into consideration?

The Plan which the Circuit Court of Appeals has found unacceptable was based on an estimate of earnings past, present and prospective, on which the Commission erected its proposed capitalization. The Commission had before it studies of earnings ending with the year 1936. In the District Court testimony was taken as to earnings later than those before the Commission, showing a substantial upward trend, and new estimates of future earnings, based on such data, were given. The District Court had before it the single question of whether it should approve the Plan as it left the Commission, and, as it did approve it, it presumably, indeed necessarily, considered that the upward trend of earnings since 1936 called for no modification of the proposed capital structure. Since that time the earnings have increased at a much accelerated rate. We believe that a stipulation will be presented by some at least of the parties making the later earnings accessible to the court on this hearing. In the *Chicago and Northwestern* case the Circuit Court of Appeals held that the court would take judicial notice of the large and undisputed increase of the road's revenues, and having thus taken judicial notice of the increase, declared it "temporary and * * * not to be taken too seriously where viewing the long future of this railroad" (*In re Chicago & Northwestern Ry. Co.*, 126 Fed. (2d) 351, 364; 7th Cir.).

As there is at the moment no plan extant vested with judicial approval (the District Court's approval of the Plan* now before the court having been reversed), it is

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* For convenience, throughout this brief the specific Plan of Reorganization now before the court is referred to as the Plan, with a capital P. The word "plan" as applied to plans of reorganization generally is not capitalized.

believed that in determining the merits and rightfulness of any plan the court will take into consideration, or direct the Commission to take into consideration, the earnings history of the enterprise brought down to date. The divergence between the meager earnings of depression years in a period ending with 1936 and the vastly increased earnings since that time might require a revision of the new capital structure. That question is discussed at length in the briefs of other parties to the proceeding, and we shall not overburden the court by contributing at length to that discussion. Our objections to the Plan are addressed to fundamental defects present in the Plan as it stands and in the present proposed capitalization. Nearly all we have to say in this brief is applicable to the Plan even on the premise of the correctness of the total of the proposed capitalization and irrespective of whether it be revised upward to reflect demonstrated increase of earning capacity. We shall make no argument as to how much or how little weight should be given to increased earnings nor as to how much their effect should be discounted as ephemeral and reflecting merely temporary improvement due to unusual conditions not likely to endure or to recur.

The capitalization made by the Plan was premised on minimum annual net earnings available for fixed charges of approximately $8,000,000. If this estimate is unjustifiably low it may not be used to deprive the first mortgage bondholders of their rights under the pledge of the road's income. It is based on earnings of years not later than 1936. If on grounds other than that of the remoteness and inconclusiveness of years ending with 1936 the Plan is sent back to the Commission for revision, the Commission should be directed on the new hearing to give such weight as it may deem proper to earnings of more recent years.

Whether the Plan should be sent back to the Commission on this ground itself—in which event it would of

course then be the duty of the Commission to give such weight as it may deem proper to earnings of more recent years—is a question to which the court must give the most careful consideration. As noted above, the Circuit Court of Appeals has said in the *Northwestern* case, and probably correctly, that the court will take judicial notice of the fact that there is currently a substantial increase in railway operating revennes The court cannot shut its eyes to the fact that the Plan is based on earnings ending with 1936. Since that time the earnings have so greatly increased that the court has ordered payment out of the road's earnings of nearly twenty million dollars of accrued interest on these bonds. The effective date of the Plan, January 1, 1939, is now a date hopelessly archaic. It is possible that the large increase in operating revenues since that time reflects not only the more or less boom conditions engendered by the war but also to some extent the permanent economies and measures of increased efficiency resulting from the long period of trusteeship when bondholders were for the most part going without their interest, when current earnings were applied in vast quantities to the purchase of equipment and a program of additions and betterments was carried through to a point representing the highest level in the history of the road. Necessarily much of this has occurred since the record before the Commission, and since the supplementary record before the District Court, were completed, but they are things of which in their aspect of objective facts, seen as a whole and not requiring detailed formulation to establish their reality, the court can hardly fail to take judicial notice.

The principle of absolute priority being maintained, there is unquestionably wide latitude available to the Commission in establishing the dividing line between fixed and contingent interest. In doing so, we should suppose that it could hardly be considered that the Commission should in 1942 or 1943 confine its consideration to earnings of

a period that ended in 1936. In its decision the Circuit Court enjoins the Commission, "*if necessary,*" to take additional evidence. Bondholders representing a hundred and fifty million dollars of invested capital are entitled to the constitutional guarantee to which, as this court said in *Louisville Bank* v. *Radford* (295 U. S. 555, 588-590) the bankruptcy power, like the other legislative powers, is subject, and should, we respectfully submit, hardly be disposed of in such casual fashion. Lawful and constitutional judgment must be enlightened judgment, and no judgment in respect to "past, present and prospective earnings," the criterion erected by the statute, can be an enlightened judgment if it ignores the history of the road's operations during the past six or seven years.

Therefore simple justice seems to demand that on the resubmission of the matter to the Commission that body be directed to propound a plan formulated in the light of earnings past, present and prospective, as the statute demands, and that any reference to the taking of further testimony be not emasculated by the addition of the words "if necessary."

At the present time the Plan has thus become infected with the vice that it is built on an estimate of earnings in which no account has been taken of the actual experience of the road after emerging from the depression. The effective date of the Plan is January 1, 1939. Whatever justification there may have been in 1940 or 1941 for erecting a capital structure which took as a deadline the performance and earnings of the enterprise through 1936 and ignored everything occurring since that time, there seems questionable justification in the closing months of 1942 for shutting the door as of a date now six years old. For whatever reason, reorganization has not been completed; judicial approval has been withheld; and even if it were considered that on the record ending with 1936 judicial approval in 1939 or 1940 would have had some justification, the fact remains that we are now at the end

of 1942 and final judicial approval has not yet been given. No new securities have been issued; the old securities are still valid and outstanding. No one has changed his position or could have changed it on the faith of what so far has been merely tentative.

It must be borne in mind that a plan of reorganization is something inherently different from a judgment. Its most striking characteristic is that, so far from asserting and enforcing existing contract rights, as does a judgment, it *modifies* them, to use the phraseology of the statute. It does this by virtue of an express legislative grant of power to do that very thing. Presumably justification is found in what are deemed considerations of over-riding public interest. The foundation of this power, its whole approach and treatment, are frankly empirical. Its purpose envisages a plan that will work, a reorganized capital structure built to weather future storms and to avert, so far as is reasonably practicable, the disruption of the enterprise when the earnings cycle is sweeping the lower arc. In doing this, it permits a plan to modify the contract rights of creditors and to erect a structure in the light of past, present and prospective earnings and of all other relevant facts; provided just compensation be made for rights destroyed. The energizing impulse exerts its force concurrently with, and not before, the judicial approval of the plan. Unlike a judgment or declaration of existing rights which in ordinary cases a court will not modify if correct when made, we have in a plan of reorganization the exercise of a power authorized to modify existing rights, which, if it is to be anything less than arbitrary power, must of necessity be based on the determination of the facts at the time the power is efficiently exercised.

III.

The Plan imposed on Bondholders now secured by an underlying mortgage the burden of a new mortgage made by a corporation obliged by its charter to operate a deficit line, thus unlawfully impairing the earnings pledged for the payment of our interest.

In the absence of a factual determination justifying impairment of the priority of the General Mortgage, the Circuit Court of Appeals properly reversed the District Court's approval of the Plan.

Under the traditional obligations of a mortgage, which are in principle recognized and so far as practicable preserved in reorganization, a mortgagee is entitled to the security of his lien. The principle of absolute priority must be maintained. This means that normally and so far as reasonably practicable he should have in the reorganized company a lien upon the same property, and the ultimate right to make the earnings of that property available for his debt, as that on which he holds his mortgage. Of course we recognize that in the public interest and for reasons of convenience and necessity this may not always be practicable. Simplicity of mortgage structure is to be desired. There should not be perpetuation of over-complex mortgage hierarchies. But simplicity of mortgage structure is not a fetish imposing the unnecessary sacrifice of property rights. There is nothing inherently impractical in divisional mortgages nor in separate corporations for separate lines belonging to a single system. Where unification is found imperative, if it would destroy existing priorities compensation must be made. In the present record there are no findings or determination by the Commission of the facts necessary to justify such a subversion of our prior lien as was attempted in the Plan. On the General Mortgage bond-

holders it would have imposed in perpetuity the burden of carrying the operating deficit of a line not owned or dreamed of when this mortgage was made. There was no showing of its necessity nor of compensation for the havoc wrought to their lien. Absent such a determination, what could the Circuit Court have properly done but to send the proceeding back to the fact-finding body?

Our mortgaged property was the definitely described established line of the Chicago, Milwaukee and St. Paul Railway Company; a property of high value and earning power and earning even in the depression more than enough to pay our interest. The Plan offered our bondholders the mortgage of a new corporation which was to own, and whose duty it would be to operate, in addition to the General Mortgage lines, a line of railway forming no part of our original mortgaged property and acquired many years after our mortgage was given. To force us to take the bonds of a corporation thus obliged to carry in perpetuity this old man of the sea would have been to decree that the payment of the annual deficit of such a new enterprise be included among the operating expenses of the railroad whose new mortgage we would have had to take. Such an intrusion into the income pledged for the payment of our interest would in the case of an ordinary mortgage not be tolerated by a court of equity nor might it ordinarily be lawfully imposed by the law-making body. To be sure, this is the case of a railway, but it can hardly be any supposed public interest that is invoked for the sake of "simplifying the mortgage structure" and to carry out a policy of reducing the number of railroad corporations in the country. There is nothing shown in the present record indicating that it would be impracticable to have separate corporate organizations co-extensive with the wholly separate and distinct enterprises represented by the original Chicago, Milwaukee and St. Paul Railway and by the western lines organized and built in subsequent years. Recognition in the corporate or-

ganization of the distinct identities of two enterprises would not mean that the western lines were to be summarily cast adrift. Doubtless operation would be continued for a substantial period under a lease or operating agreement with the original company. Indeed, the Commission has not found that such operation could not be continued, nor that the existing lien of our mortgage could not be preserved without impairing our right to resort to the net income of our own mortgaged property free from liability to diversion to pay operating deficits on another line. The Commission simply suggested that such a mortgage structure would be too cumbersome, but we contended that the integrity of our mortgage lien might not be lawfully impaired in such an easy way nor so summarily dismissed. Indeed, so far as appears, the Fifty-year Mortgage interests themselves do not question the practicability or advisability of separate organizations for the two roads. They have a second mortgage on our lines, to whose benefit they are entitled. We have no lien on their lines and it is contrary to law that such a juggling and distortion of liens be willy-nilly imposed upon us with the burden of carrying in perpetuity the operating deficit of a line not in existence or conceived of when our mortgage was given.

The bonds issued under the General Mortgage had behind them the security of a first mortgage, at the rate of $25,000 per mile, on one of the major railway systems of the country, a first lien on the heart and indeed on practically all the system, extending over more than 6,000 miles of track. To quote the language of the Interstate Commerce Commission (No. 17,021. "Investigation of Chicago, Milwaukee & St. Paul Railway Company. Submitted January 14, 1927, Decided January 1, 1928", 29 I. C. C. 615; introduced in evidence, 1721): "For many years the St. Paul had been considered as one of the strongest railroad properties" (p. 615). Our mortgage was placed on the road in 1889. Its interest requirements

were abundantly covered. The operation of the mortgaged lines continued to yield ample funds for interest requirements, and in 1905, shortly prior to the expansion program about to be outlined, after continuous payment of substantial dividends, the road was earning its interest requirements three times over (*ib.*, 618). In fact there has been practically never a time when the operation of our mortgaged lines has failed to earn ample coverage for the interest requirements of our mortgage. There may have been short periods of failure, but there has been no substantial gap; these lines have earned their interest throughout this proceeding, a period mostly within the depression, and are far more than earning it today. Investors purchasing bonds under our mortgage had before them established and demonstrated continuous earning power of the mortgaged lines showing ample security for their investment.

In the first decade of the present century the management of the road conceived the idea of a great new enterprise; of another railroad to connect with the mortgaged lines. The mortgaged lines made an integrated and coordinated system whose main axis ran from Chicago to the Missouri River, serving a well defined region with its western terminus at Mobridge, on the Missouri River. The country west of Mobridge was served by two trunk lines, the Great Northern and the Northern Pacific, running through long stretches of uninhabited territory and crossing three mountain ranges. Two new transcontinental lines were being built in Canada almost contemporaneously with the emergence of this plan, the Union Pacific was building various lines in the northwest and the Panama Canal was being pushed to completion (*ib.*, 622).

Some one had the idea that to build a railroad from Mobridge to the coast might cost approximately $45,000,000. As for any contemporary judgment by any one in authority, there is hardly anything deserving more definite characterization. The Chairman of the Board wrote

to the President in 1901 that "we could build a line to the coast and supply terminals for $45,000,000" (*ib.*, p. 616), and an engineer was "sure that it would not cost as much as $45,000,000 to build as good as the Northern Pacific to the coast," but this was before he started on his trip on that road (*ib.*). The fact is that the ultimate cost in road and equipment of the lines west of Mobridge was $256,968,126 (*ib.*, p. 619), and in the course of its subsequent investigation the Interstate Commerce Commission reported that "we have been unable to find that any engineering or traffic surveys were made" (*ib.*, p. 618).

> "It is clear * * * that the project was started with no adequate comprehension by those controlling the destinies of the St. Paul of its probable cost * * * and * * * that little, if any, consideration had been given to the building or acquisition of branch lines and feeders later found necessary to secure traffic" (*ib.*).

At that time it was not necessary to secure from the Commission or from any one a certificate of public convenience and necessity, and "personal rivalries and ambitions were free to do as they willed with a great property" (*ib.*).

This gigantic venture, whose cost proved to be five or six times the airy estimate on which it was undertaken with no adequate engineering or traffic surveys to show its probable cost or prospective returns, was on the face of it no normal development of the mortgaged enterprise on which our bonds had been issued. If was a new undertaking, an extension into a new field, finding its consummation in the acquisition of another railroad. Until the end of 1912 the two lines were owned and operated independently, and on December 24 of that year the Chicago, Milwaukee & Puget Sound conveyed the property to the mortgagor (*ib.*, p. 619). Needless to say, it was an undertaking in which the General Mortgage bondholders took no part. There was, indeed, no legal obligation to

consult them in the matter; but even the stockholders, who were directly interested, were left pretty well out of the counsels of the management. "It is obvious that the stockholders in general had no voice in the momentous decision" (p. 618).

It is not disputed that on the record before the Commission the western lines had failed to earn enough to cover operating expenses. In the briefs before the Commission on behalf of the Fifty-year Mortgage trustee and its bondholders there were analyses of the current deficits from which it is claimed that they might be turned into a slight surplus, but no one contended that the lines had yielded net operating income. The absorption in the capital structure of this investment load of some $260,000,000, and the enforced payment of interest through the thirty years since its undertaking, were of themselves enough to account for the road being today in a reorganization court. The definite categorical conclusion of the Commission, reached after exhaustive presentation, was (1307-8) that

> "We are satisfied that on any reasonable basis of allocation between the lines west and the other parts of the system, the lines west cannot be expected to earn any sum for the payment of interest."

The evidence of system operation, it was found,

> "does not demonstrate any earning capacity for the western lines" (Commission's Report of June 4, 1940, 1307-8).*

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* Since the period considered by the Commission the earnings of the western lines have greatly improved. At the moment they are, we believe, highly remunerative. Profitable operation after thirty years deficit strikingly emphasizes the danger of allotment of bonds under a new blanket mortgage as a fair equivalent of existing bonds secured by lines as disparate as the old Milwaukee and the lines west of the Missouri River. In dealing with a subject matter so volatile and uncertain, the Circuit Court properly insisted on thorough and exhaustive determination of the facts.

Of course those who lend money to a railroad on the security of its mortgage bonds have no standing to insist that the road shall not take on other railroad properties, nor that it may not continue to operate them even at a loss, thereby reducing the surplus income available for interest. So far as the bondholders are concerned, this process may go on so long as the road continues to pay the interest on its bonds, even though the result be the stripping of the road's available revenues and the impairment or even annihilation of the backlog in the form of surplus which had constituted an important element of financial security to the bonds. That is one of the risks the investor takes.

But on default in the payment of interest the question of severance becomes of importance. If the mortgage be foreclosed, there is an intervening period before the sale of the mortgaged property during which the bondholders or mortgagee will ordinarily have no power to eliminate the draining off of the earnings to pay the operating deficit of the unprofitable lines; but when foreclosure has been completed the bondholders, if they be the purchaser at the sale, or if not they then whoever may be the purchasers, take the mortgaged property which they have now bought and take nothing except what they have bought. From that time on, the operating revenues of the property which they have bought may not lawfully be taken from them to pay operating deficits on other property not owned by them and in which they have no interest.

To state this is but to state one of the most elementary principles of property right. If this were not so, and if on realizing on his security a mortgagee might be obliged to take and operate, as an organic and inseparable part of a single enterprise, other property which the mortgagor had acquired, wholly separate and distinct from the mortgaged property, whose operation by the purchaser would mean a continuous drain on the income of the

property he had thus bought, he would be deprived of his property no less effectively than if the court each year were to compel him to pay over part of his income to the owner of the unprofitable property.

A purchaser of a railroad at foreclosure sale does not succeed to the corporate existence, but succeeds to the right to operate the road (Cook on Corporations, 8th Ed., Sec. 890; Vol. V, p. 4164).

> "The mortgagee and the purchaser at the foreclosure sale are not bound by contracts of the mortgagor made subsequently to the execution of the mortgage, whether those contracts are leases, sales, mortgages, guarantees, traffic contracts, or debts."
>
> Cook on Corporations (8th Edition), § 890; Vol. V, p. 4169;
>
> Rogers v. Nashville, etc. Ry., 91 Fed. 299, 320-1 (U. S. Cir. Ct. of App., 6th Cir.; TAFT, LURTON and SEVERENS, JJ.).

A purchaser of a railroad at foreclosure sale is not liable for the debts of the old company.

> Cook on Corporations, Sec. 890.

> "A carrier cannot be compelled to carry on even a branch of business at a loss, much less the whole business of carriage • • • It is true that if a railroad continues to exercise the power conferred upon it by a charter from a State, the State may require it to fulfill an obligation imposed by the charter even though fulfillment in that particular may cause a loss. *Missouri Pacific Ry. Co.* v. *Kansas*, 216 U. S. 202, 276, 278. But that special rule is far from throwing any doubt upon a general principle too well established to need further argument here."
>
> Brooks-Scanlon Co. *v.* R. R. Commr., 251 U. S. 396, 399.

> "They (the purchasers at foreclosure) bought the property of that company and its franchises; but if,

as such purchasers, they became bound to pay all the debts and perform all the obligations of the corporation whose property they bought, it would put an end to purchases of railroads."

Hoard *v.* C. & O. Ry. Co., 123 U. S. 222, 226-7.

The franchise to be a corporation does not pass to the purchaser on foreclosure (Cook on Corporations, Sec. 790), but the purchaser does acquire the right to operate the road, and this right may not be destroyed by amendment or repeal of the mortgagor's charter subsequent to the execution of the mortgage.

People *v.* O'Brien, 111 N. Y. 1.

There are few principles in the law of corporate finance more firmly established than that while the mortgage grant does not vest in the purchaser on foreclosure the right to be a corporation, it does operate to vest in the purchaser the right to operate the mortgaged property and that he is entitled to receive such franchises as may be necessary to assure full effect to that right. As the court said in that case:

"It follows that if the franchises of a railroad corporation, essential to the use of its road, and other tangible property, can by law be mortgaged to secure its debts, the surrender of the company carries the franchises and they may be sold and pass to the purchaser at the bankruptcy sale" (p. 44).

But the Commission's Plan had attempted to deprive our bondholders of precisely that. The Plan declared in effect that as a condition of the exercise of the right pledged under our mortgage a purchaser on foreclosure would also have to operate, as an integral and organic part of the system, another railroad whose existence had not even been contemplated when our mortgage was made; and this although the other road was and almost from its inception had been unprofitable and not only added no

earning power to our lines but actually absorbed year by year a substantial part of our earnings by imposing its operating deficit thereon and directly diverting a substantial part of the earnings of the road that was mortgaged to us.*

Suppose that after the giving of our mortgage the mortgagor company had made an agreement with the Chicago, Milwaukee & Puget Sound (original owner of the western lines) by which it had guaranteed the payment from time to time into the latter company's treasury of any operating deficit on that company's lines, and suppose that as security for such guaranty it had placed a prior mortgage on the lines already covered by our mortgage. Would one be heard to say that such mortgage given to the Chicago, Milwaukee & Puget Sound was other than a second mortgage, or that on foreclosure of our mortgage the purchaser would not take our mortgage lines free of the burden of the second mortgage? Yet between that and the burden imposed on us by the Plan there is nothing but a difference in form. Under our mortgage the purchaser on foreclosure would acquire our mortgaged lines and the right to operate them; but on this the Plan would superimpose the burden of the perpetual charge of the operating deficit on the western lines, with no other source of right than a mortgage executed years after our mortgage. If this be not subverting *pro tanto* the lien of a first mortgage to that of a second mortgage, by what term shall we call it?

Of course this does not mean that there must be as many railway corporations as there are railway mortgages. We presume that normal and incidental accretions and even additions may to a reasonable extent be integrated with a mortgagor's railway system, and that a purchaser on foreclosure may, within reasonable limits and

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* As to current improved earnings, v. footnotes, pp. 28, 44.

with proper adjustment of property rights, be compelled to take, for example, minor branches and other property distinctly appurtenant to the mortgaged line. Such problems may usually be solved by fair and reasonable adjustment. But if they cannot be so adjusted there must be severance. If this were not so, if as a result of purchasing railroad bonds, covering properties known and analyzed and with fair opportunity for judgment, investors have to take the risk of having separate and distinct enterprises thrust into their lap, their deficits made a year by year charge on the property securing the original bonds, what safety will be left in railroad bonds as investments?

The principle, we repeat, is not a new one. It has been applied again and again. The financial records are full of cases of railway systems acquired on foreclosure. It is to the public interest, it is said, that existing railway facilities from the Missouri River to the coast be maintained unimpaired. That may or may not be correct. It is quite as likely that the public interest may best be served by sound and reasonable coordination, cooperation; and the cutting out of unnecessary duplication and destructive competition. But whatever the public interest may demand, public interest comes vested with no right to impose on the holders of first mortgage bonds of remunerative railway system the burden in perpetuity of paying the deficits on separate and distinct railway enterprises undertaken by the successor by consolidation of the mortgaged railway.

Of course this does not mean that today or tomorrow or this year the Milwaukee is to cease operation of the unprofitable western lines. Section 77 itself forefends quick deprivation of service. The lines should be run for a time under an operating agreement, and it may take several years for the corporation owning the western lines to work out, by coordination with the existing parallel roads, a fair solution, in the public interest, of its transportation problems. The essential requirement is that it be a sepa-

rate corporation and that the working out of its problems be not cast on the bondholders under a mortgage on another road antedating by a score of years the ill-advised venture of the superfluous western lines. It is bad enough to have an old man of the sea about our neck. The Commission's Plan would make of it a Siamese twin, to justify which we need a new conception of a mortgagee's rights and of what is meant by the law of the land.

The separate organization and operation of two railways, even where they have existed for many years as a single integrated entity, is not in conflict with either recognized practice or authority. There is no public interest justifying (assuming that a public interest could ever justify a destruction of rights conferred by mortgage) the continued retention, after mortgage default, by a mortgagor corporation of an unprofitable appendage acquired many years after the mortgage was given and imposing on the corporation annual operating deficits. Throughout the country there are many examples of united roads giving the public all the advantages of unified management while maintaining the integrity of their separate corporate structures. The Wisconsin Central, for instance, and the Soo line are practically operated as a single line. The public regards them as a single line and they give the integrated service of a single line. But the identity of the two lines is exactly preserved. The Wisconsin Central is operated by the Soo and is regarded by the public as part of the Soo, but it has its own capital structure and its own funded and unfunded debt and each road is working out its own separate reorganization. The Minneapolis and St. Louis, whose long drawn out reorganization, now approaching a score of years, has made it a veteran in the courts, is told by the Reconstruction Finance Corporation that it can not have its needed loan for reorganization unless it does divide its lines and corporate entity between two corporations, and in a long opinion the Interstate Commerce Commission approved the plan for separate

corporations (*Minneapolis & St. Louis Railroad Co. Reorganization*, 244 I. C. C. 357), providing for an operating agreement between the two companies, precisely as we are asking here. As the Commission there says (p. 375):

> "While the operation of the properties of the new company and the new corporation will be entirely independent, as stated in the contract, from a practical standpoint there will be a mixed operation, and the service to the public will be the same as if there were a single ownership. Any changes in service, freight or passenger, will be for the purpose of adapting the service to the traffic and in the interest of economy in operation. *Operating efficiency of the system in general will neither be impaired nor promoted by the 2-company plan.* * * * The new company and the new corporation will be considered as one railroad for the purposes of making rates, and no tariff changes will be made having for their purpose the diversion of traffic from the lines of the new corporation to those of the new company."

If we may not foreclose but in lieu thereof must take new bonds we have the right to insist that they be the bonds of a railway company owning and operating a railway substantially identical with that covered by our mortgage, and that the railway corporation owning and operating the western lines shall not have the right to withdraw from our treasury year after year the annual recurring deficits of the western lines; or if this cannot be done that proper compensation be made. There is in this record no finding that it cannot be done, nor is there hint of compensation. By foreclosure of our mortgage the consummation of our present potential ownership would come to us untrammelled by any such burden, and if by reason of a compulsory reorganization such remedy is denied us, the rule of absolute priority, declared in the *Los Angeles Lumber Company* and *Consolidated Rock Products* cases to prevail with unabated force, entitles

us to a bond free from the incubus of an operating charge on another enterprise called into being long after our mortgage was given and our bonds issued.

The Commission's report being destitute of the determination of facts showing justification for this drastic making over of the General Mortgage lien, or of the necessary compensation to its bondholders, the Circuit Court properly reversed and remitted the matter to the Commission for determination of the facts.

IV.

There was no factual foundation for the new contract with the Terre Haute which the Plan would have imposed on the reorganized road.

We shall refer but briefly to the Terre Haute situation. On the matter being remitted to the Commission it should be thoroughly re-examined there.

So far as the present review is concerned, it need only be said that there was no foundation of established facts justifying the amazing largess offered by the Plan to the Terre Haute bondholders. With a thinly secured series of bonds on some 300 miles of main lines subject to the first lien of the General Mortgage, as compared with the 6,000 miles of main lines subject to the first lien of the General Mortgage, the capital investment representing $21,929,000 for the Terre Haute as compared with $136,368,930 for the General Mortgage bonds (disregarding the pledged bonds held by the RFC), the Plan would have actually given the Terre Haute $603,047 of the small available fixed charge interest, as compared with $1,563,682 to the General Mortgage. Almost a third would have gone to a poorly secured mortgage on 300 miles as compared with not much over two-thirds to the fully secured underlying mortgage on the 6,000 miles of main line.

The Terre Haute bonds represent a lease to the Debtor of property worth less than the mortgage debt. Its possible earnings hang by the thread of the permanence of the present use by the Debtor of coal mined along the Terre Haute lines; a tenuous reliance, altogether likely to prove illusory whenever a better or cheaper coal supply is found, or, more threateningly, when the apparently inevitable obsolescence of coal locomotives and the Diesel engines' superseding of the old equipment shall have become complete. The Terre Haute lines are not themselves parties to this proceeding nor in process of reorganization. Disaffirmance of the lease will leave the whole situation wide open, and it is hard to believe that directors mindful of the best interests of the debtor would renew the lease. Why, with this contribution of such dubious value, the Commission should have exalted the Terre Haute bonds to the dizzy rank of practical priority over most of the General Mortgage bonds, we are utterly at a loss to conceive. In setting up the new First Mortgage these Terre Haute bonds simply do not belong in the picture. Their proper treatment is to be left undisturbed, with disaffirmance of the lease. Incredible as it seems, although the management is now free to disaffirm the Terre Haute lease, the Plan actually proposed that the new company guarantee these bonds and impose their $21,929,000 of debt on the new company, and this on lines with a mileage of 340 miles, valued by the Interstate Commerce Commission at $20,680,114 (2212), or about 95 per cent of the $21,929,000 of bonds. Their holders were thus to have $21,929,000 of guaranteed bonds as compared with $39,092,045 for the old General Mortgage bondholders with their first lien on the 6,000 miles constituting the heart of the system and providing nearly all its revenues. The proper treatment of the Terre Haute lines is obviously a simple operating agreement, that may be renewed from time to time as the future may develop and so long as the management finds such an agreement the best way of

securing transportation for its coal; a use that may in the not distant future be much curtailed. We have enough inequities to expose in this brief without going in detail into the monstrosity of this largess for the Terre Haute, and as that is fully covered in the brief on behalf of the University Group of objecting General Mortgage bondholders we refer to that brief and will not burden the court with repetition.

A plan should simply recommend to the reorganized company that it negotiate a new contract. All that the Commission found and determined about the Terre Haute was on the whole critical rather than otherwise. There was no finding of anything in the nature of compensation to the displaced General Mortgage bondholders for being thrust from their position of priority nor for the filling of their place, to that extent, by the holders of the Terre Haute bonds. An altogether minor factor in the system has intruded where the corner stone belongs.*

* The genesis of the Terre Haute bonds, and the marvelous emergence of the system from a distress property looking for a financial angel into an enterprise whose bonds shove first mortgage system bonds out of the way, is revealingly told in the Interstate Commerce Commission's Report of "Investigation of Chicago, Milwaukee & St. Paul Railway Company" of 1928 (see especially pp. 653-660; introduced in evidence, 1721). "We think that the record shows that in a desperate effort to justify the acquisition of the Terre Haute by increasing commercial coal shipments the St. Paul has come perilously near to granting undue concessions to a few large operators on the Terre Haute" (p. 660).

V.

By its mandatory additions and betterments fund the Plan would have unlawfully withheld from the General Mortgage bondholders $62,500,000 of first mortgage fixed interest bonds to which under their absolute priority they were entitled.

We have objected to the deduction by the Commission of a mandatory additions and betterments fund, fixed at $2,500,000 per year. The purpose of this fund, as the name indicates, is to provide for *capital* expenditures. We have contended, as a matter of law, that the prospective minimum net earnings available for fixed charges must under the principle of absolute priority be made available to our bondholders; that to divert them to capital expenditure for the benefit of the equity would be to violate our legal and constitutional rights. If in the public interest it were deemed that such expenditures must be made and that there were no source other than earnings from which to make them, then if earnings contractually available for our interest were resorted to, this would in effect be a forced loan and we should be entitled to contingent interest bonds, fully cumulative, preserving our right to have such forced loan made good upon there being subsequent net earnings available therefor.

The practical effect of interposing this $2,500,000 mandatory additions and betterments fund among the fixed charges, where we contend it has no place, would of course have been to diminish to that extent the income available for interest on the new first mortgage bonds; in other words to reduce by $62,500,000, (the capitalized value of such $2,500,000) the amount of bonds available for the present holders of underlying mortgage bonds. This raises, of course, as we have just pointed out, the fundamental question of law whether under the established

principle of absolute priority it is permissible to withdraw from the income pledged to the underlying mortgage bondholders this large sum desired for capital additions and betterments; or, even assuming that in the public interest this may be done, whether if so done it may be properly treated as anything other than a forced loan by the underlying mortgage bondholders which should be repaid should further earnings supply the means. The latter object would be accomplished, so far as it may be, by giving the underlying mortgage bondholders, for an amount equal to the fair capitalization of the portion of interest so withheld, contingent interest bonds with interest fully cumulative. Under the Plan, however, they by no means were to receive fully cumulative contingent interest bonds for the portion of their debt not represented by new fixed interest bonds. Under the succeeding categories they were to receive 55 per cent of their debt in contingent interest bonds, but these were not to be fully cumulative, the accumulation being limited to three years, and for 20 per cent of their holdings they were to receive the wholly illusory distribution of new preferred stock, represented by certificates bearing it is true a figured inscription reading "$100" each but representing in fact a share in earnings which under the present and any reasonably prospective tax structure would be wholly or for its greater part absorbed by taxation and would never reach the stockholders.

Capital funds of this kind, appropriated out of the net income already pledged to mortgage bondholders for the payment of their interest, have been coming much into fashion among current proposed plans of reorganization, but have not yet been considered by this court. Of course the effect of such a Plan is to make use of net income to enrich and fortify the physical assets of the enterprise while the bondholders must, to that extent, go without their fixed interest, trusting to find it, if the earnings continue high enough, somewhere farther down the line.

Additions and betterments are not a new category in railway financing. They inherently are and always have been considered a capital charge, quite distinct from maintenance, and they have always appeared in the capital account. The principle or guiding concept of the present fashion is precisely the same as that which would be applied if a farmer who had mortgaged his farm, specifically pledging its net income, were to announce that his farm would be improved by the construction of a silo and that he had decided to use the net income of the farm to build a silo instead of to pay the mortgage interest, and such a modification of the mortgage were to receive judicial sanction.

Whether such a diversion of net income may lawfully be mandatorily imposed in reorganization on a railroad with the immediate, simultaneous and necessary consequence of cutting down its available fixed interest mortgage obligations is to say the least a novel question. Certainly the principle has never been announced by this court, and it presents a question that emphatically ought to be settled by this court. The decision below asserts that such diversion of income and subversion *pro tanto* of mortgage lien is quite legal. Indeed the court declares (2313) that "In fact we find few things in the Plan which appeal stronger than this provision," but this is all it has to say about its legality. Of that there is not a word of discussion or exposition.

The problem of providing for additions and betterments without unlawful destruction of liens whose right to the maintenance of their absolute priority has received the repeated sanction of this court is of course a difficult one. We are confronted by the inescapable fact that a railroad must have additions and betterments and that the financial sources of outside capital traditionally available therefor are not so plentiful as they have been. The Plan, however, provides for an open first mortgage, the first series of which is of such small amount that it seems unduly pessi-

mistic to regard the sale of bonds under other series as wholly excluded. The diversion of pledged income to capital additions and betterments runs counter to the whole spirit and foundation of the decisions of this court upholding the principle of absolute priority. If on some theory to be now established this may lawfully be built into a plan of reorganization at all, it can be nothing other than a forced loan. If that could be done, the displaced bondholders must receive at the very least contingent interest bonds whose interest, if thereafter earned, may repay the loan thus forced from them. This vital question of additions and betterments to enrich the equity at the expense of secured bondholders is most emphatically one on which this court should at the earliest opportunity, afforded by a concrete case such as the present, announce the legal principle to be observed in such cases.

For many years under the Commission's accounting rules it has been necessary to charge additions and betterments to capital account and to finance them either from free surplus earnings or by the issue of new securities. In no event has it been possible to resort to what is proposed here—the illegal device of taking income already pledged to the payment of mortgage interest and diverting it to the cost of capital improvements. Certainly on this whole question of provision for additions and betterments it is of the highest public interest that this court state clearly and unequivocally the principle applicable to such a situation. Otherwise the prevalent intrusion into the income account of additions and betterments funds will cast an ominous shadow on the whole field of future railway investment. In short, this issue presents an important question of law which has not been, but should be, settled by this court.

Considerations of practical necessity may lead to the treatment of such capital charges as though they were, as the upholders of the Plan describe them, really in the nature of charges for maintenance. It must be remem-

bered that the normal source of supply for additions and betterments funds in excess of what is realized from new curities has always been found in the depreciation and retirement allowances; sources which have heretofore proved adequate. For many years the accounting rules of the Commission have imposed mandatory depreciation for equipment but have left it optional with the carriers whether they should set up depreciation on roadway and structures. If depreciation were applied on roadway and structures it is not unlikely that this would so augment the fund available for additions and betterments as to render unnecessary the withdrawal from income available for charges of the mandatory additions and betterments fund proposed by the Plan. By an accepted modification of the Plan engrafted on it by the District Court, any such funds made available by the setting up of depreciation on roadway and structures must be credited as contributions to the mandatory additions and betterments fund proposed by the Plan. By an accepted modification of the Plan engrafted on it by the District Court, any such funds made available by the setting up of depreciation on roadway and structures must be credited as contributions to the mandatory additions and betterments fund, and in any year when such contributions equalled or exceeded $2,500,000 there would be no withdrawal of that amount as an additions and betterments fund taken from earnings available for fixed charges.

The Commission has recently (June 8, 1942) issued an order making it mandatory to set up depreciation on roadway and structures, effective January 1, 1943. It is likely that for the future this will render the question of the legality of such a mandatory additions and betterments funds as was proposed by the Plan largely academic. Of course it will not change the net result; that is, the net income available for charges will have been diminished by the amount of the charges made for depreciation of roadway and structures, an amount presumably

not very different from what the Plan had proposed to take out for additions and betterments, and the amount so taken out will go for capital expenditures. Additions and betterments will have been paid for from income, and the amount available for mortgage interest will have been thereby decreased. But it will have been done legally, because depreciation is a charge properly made at the expense of income.

But the difference is not merely one of terminology, or of using one accounting set-up rather than another. If the withdrawal be made by establishing depreciation, the result is that net income is diminished; whereas, if the withdrawal be made by setting up an additions and betterments fund out of net income, net income is not diminished, but a portion of it is merely applied to a certain purpose, just as if it had been used to pay a capital debt. The practical difference is enormous, for under the present and prospective tax laws the greater part of net income will be intercepted by taxation. Therefore it is of the utmost consequence that if, as the proponents of the Plan contend, additions and betterments are really in the nature of maintenance and therefore payable out of income, this court should explicitly so declare and that their payment should go into the account at the proper, logical and only correct place; namely as a charge paid before net income is computed. This means that any plan should make additions and betterments charges payable from depreciation funds, reached before net income is computed, and should not take them out of net income; for to take them out of net income, as the Plan had proposed, would, in view of the latter's immediate subjection to an enormous tax, have been to make "net income" an illusory entity.

IN CONCLUSION.

The order of the Circuit Court of Appeals should be affirmed and the matter remitted to the Interstate Commerce Commission, with such statement of the fundamental principles to be observed in the formulation of a plan of reorganization as to the court shall seem proper.

All of which is respectfully submitted.

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